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## Rating the Law: How Financial Rating Agencies are Assessing the Legal Risks of Financial Transactions

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# Rating the Law: How Financial Rating Agencies are Assessing the Legal Risks of Financial Transactions

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## Summary

Financial rating agencies are key actors of financial markets. Their different ratings are usually pre-conditions for issuing securities or bonds. If they assess the financial viability of the financial instruments issued, they also assess the soundness of the legal arrangements used. Thus, taking the law into account is a key element of their assessment. At a macro level, their ratings may express an opinion of the economic attractiveness of a territory. The same may apply to the legal framework used by issuers. Surprisingly, the literature on this topic reveals to be scarce. This paper aims at fulfilling this gap<sup>1</sup>.

It studies, in particular thanks to interviews, how rating agencies consider the law while rating a country, an enterprise or a financial structured instrument. One of the hypotheses we wanted to test was whether financial rating agencies use synthetic indicators of law and institutions effectiveness such as those of IFC (World Bank Group) *Doing Business* annual reports and if there are biases for or against certain legal traditions. Firstly, this study assesses the relatively informal methodology used by the rating agencies to assess the “quality” of the legal framework of instruments issued on markets. Secondly, the study reveals in particular the existence of several biases: a general prejudice against Case law and a specific bias in favour of Common Law jurisdiction. This study reveals that, on average, due to the limitations of the ranking used by rating agencies, *all other things being equal*, corporations or bonds issued from countries unduly ranked should suffer from this prejudice. The paper tries to quantify the sensitivity of rating models to the assessment of the “quality” of the legal environment. Finally, this paper considers what regulation framework would help to cope with the exhibited drawbacks and to improve the fairness and the effectiveness of the rating process.

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<sup>1</sup> This paper draws from a more comprehensive report written in French for the “Economic Attractiveness of Law” research program under the direction of B. du Marais with the same co-authors and Hubert de Vauplane (General Counsel, CALYON Credit Agricole), and with the research assistance of PhD Students F. Besson (Economist, Matisse, University of Paris I), E. Suel (Lawyers, CRDP, University of Paris X Nanterre) and P. Froute (Economist, University of Paris I and ESSEC). The “Economic Attractiveness of Law” research program is partly financed by the “GIP Mission de recherche Droit et Justice”.

## I. Section I: Introduction

### A. The goal of the paper

Credit rating agencies (CRAs) are key players for the regulation of financial markets. Their different ratings are usually pre-conditions for issuing securities or bonds. If they assess the financial viability of the financial instruments issued, they also assess the soundness of the legal arrangements used. Thus, assessing the soundness of the legal instruments is a key element of their ratings.

At a macro level, especially for sovereign bonds, their ratings may express an opinion on the economic attractiveness of a territory, if not on the level of the Rule of Law. Economic competitiveness (for a firm or a country) is increasingly resorting to intangible parameters that are related to the legal and institutional environment of the economic transactions: “governance matters”.<sup>2</sup> Therefore, the collection of opinions of CRAs on the law used by issuers from a certain country may be a good proxy of the attractiveness of its legal framework.

From an analytical point of view, the so-called “Law and finance” literature from the LLSV team<sup>3</sup> has shown the relationships between the legal framework and the development of financial markets. A key determinant of the growth of financial markets is said to be the legal origins of financial law. To belong to the common law tradition should be an asset for financial transactions, and hence to economic development. More generally, LLSV’s results confirm other analyses that show that common law provides a better environment for economic transactions, since it is supposed to better secure property rights: legal origins matter.<sup>4</sup> Following this results, several authors<sup>5</sup> and institutions<sup>6</sup> have built composite indicators in order to capture the effect of legal systems on economic development. They thus switched from correlation to causality, yet using a rather questionable methodology.<sup>7</sup>

The main goal of the present paper is to assess whether CRAs share these judgements and if they also demonstrate the superiority of common law through

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<sup>2</sup> KAUFMAN and al. (1999).

<sup>3</sup> LA PORTA, LOPEZ DE SILANES, SHLEIFER and VISHNY (1998).

<sup>4</sup> GLAESER and SHLEIFER (2002).

<sup>5</sup> See DJANKOV and al. (2006).

<sup>6</sup> See World Bank (2003).

<sup>7</sup> MÉNARD; DU MARAIS (2006).

the sound and rigorous assessment that CRAs are supposed to do with the legal arrangements used by issuers.

We then investigate three main issues:

- How (CRAs) actually assess the “quality” of the legal arrangements used by issues? What is their methodology in this respect?
- More specifically, are these governance composite indexes – especially the Doing Business index published by the IFC (World Bank Group)<sup>8</sup> - used by the CRAs to build their rating?
- And more generally, are CRAs neutral or biased for any specific legal tradition or legal instruments?

## **B. The methodology**

Our methodology is a standard one. We used interviews of a sample of stakeholders: the three major CRAs (Standard & Poor, Moody’s and FitchRatings) operating in France and some non credit rating agencies (NCRAs) involved in socially responsible investment; top managers of all kind of issuers (sovereign, corporate and also structured finance issuers); attorneys and managers of the regulators. These interviews led to focus on some case studies. We identify a few examples where CRAs had a specific and recordable influence on the evolution of substantive law itself. This qualitative survey has been supplemented by a principle component analysis of the ranking and methodology used by one of the 3 main CRAs (FitchRatings) for assessing one of the key parameters of the ranking: the soundness of national bankruptcy law. One has to stress that, due to budgetary constraints; this research has only been done on France. By another caveat, we should stress the difference we identified between CRAs and NCRAs. Since this paper focuses on CRAs, we would only refer interested readers to the extended version of the research<sup>9</sup>.

This research focus on the influence of CRAs on the access to market. On secondary market, the fluid functioning of the fin market should compensate for the bias: notably thanks to arbitrage activity and the competitive incentives between the three CRAs.

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<sup>8</sup> World Bank (2003).

<sup>9</sup> See the full report in French, available on demand at [aed@u-paris10.fr](mailto:aed@u-paris10.fr) and to be published in September 2007 by La documentation française: [www.ladocumentationfrancaise.fr](http://www.ladocumentationfrancaise.fr).

However, the latter point remains problematic in our view, indeed if all agencies possess exactly the same bias, then competitive process would be insufficient to correct it. Thus it can only be corrected through arbitrage processes.

Section II identifies the issues at stake, namely the effect of CRAs opinion on the legal arrangements used by issuers, from a scientific, then financial and finally regulatory points of view. Section III develops our findings. Through specific cases studies, we confirm that CRAs play a role in terms of recommending, at least indirectly, specific legal arrangements due to some unquestioned bias against some other legal arrangements. This is all the more troubling that we found their methodology rather loose, if not some time lacking transparency. In particular, we identified at least some instances where CRAs use very questionable indicators of the quality of law. Section IV draws the conclusions of these findings in terms financial market regulation and further research.

## **II. Section II: the issues at stake**

From a scientific point of view and surprisingly, the literature on this topic reveals to be scarce. This paper aims at fulfilling this gap. From a financial point of view, the stakes are paramount since financial rating directly determines the financial cost for the issuer if not the mere ability to issue a financial product. From a regulatory point of view, the stakes also are high since CRAs are more and more often called upon to be part of the regulatory framework of the financial market, especially with the implementation of the Basel II convention in the realm of banking.

### **A. The relative lack of literature on the legal component of financial rating**

If the literature concerning the history and the functioning of CRAs, as well as the literature on the relevance of ratings are relatively abundant, we found quasi nothing concerning their legal components. Admittedly, since transparency injunctions made by the IOSCO (International Organization of Securities Commissions) in 2004, CRAs disseminate some information through documents like European legal criteria from Standard & Poor's. But this information is very often confined in the statement of general principles which do not make possible to look further inside the "black box" of the rating process and methodology. Some works assess the role of Law into ratings but for country risk ratings, as with the International country risk guide, as assessed by GUES-

SOOM (2004). However, these ratings are usually seldom used by financial market operators. The other works we consulted dealt with the question in a broader way. They were concerned with taking into account institutions according to a methodology very close to the Law and Finance stream. For instance, Godlewski shows that the ratings are consistent with the results of La Porta et al.<sup>10</sup> This last result consolidated us in our project to study if the observed correlations were due to the use by CRAs of existing indicators potentially fraught with some biases or if they resulted from an autonomous, yet convergent analysis carried out by CRAs. This question can be summarized in the following alternative: Are CRAs using a wrong methodology in aggregating and interpreting legal data or are they using misleading data?

## **B. A financial stake for rated entities**

Needless to say, the impact of the rating, expressed in “notches” (as AAA, AA+, etc.) by the three major CRAs, is paramount for an issuer on the financial markets, especially with the view to accessing to investors.

The rating has a direct effect on the cost of the funds levied on the markets. Sometimes, to get a poor rating actually leads to cancel the issuance of a security or a bond, because of the reluctance of investors to buy low rated papers. For corporations, being downgraded can accelerate bankruptcy. Therefore, if CRAs have an unjustified bias against some specific legal arrangements or legal traditions, this bias may have a direct negative effect on the balance sheet of issuers, but also may prevent investors to benefit from otherwise sound financial opportunities. One can argue that market mechanisms should lead purchasers to demand these instruments because they would get higher interest rate and consequently lower price. Put it another way, arbitrage and incentives should correct the gap. The existence of such corrective mechanisms is an important issue and should deserve attention. Nevertheless, one can presume that they are not short term mechanisms. Since our study focuses on the access to market, therefore we put aside this point.

One can also argue that if such a bias exists, then it would be rarely equally expressed by all three agencies. The competition in the market for rating will then correct this bias because the biased agencies will have a strong incentive to improve their methodology and suppress their bias. However, if the intensity of competition in this market seems to grow, it remains an oligopolistic com-

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<sup>10</sup> GODLEWSKI (2004).

petition. Moreover, there is a risk that all major agencies possess the same bias. In this regard, many researches traditionally show a strong correlation between the ratings given by the three major agencies.<sup>11</sup> Therefore, if this bias is constant and uniformly shared by the CRAs, then the fin market will itself follow this bias. Issuers and buyers will not be able to correct this bias and the access constraint will remain.

Our analysis focuses on identifying the sensitivity of the rating to the nature of the law used by issuers.<sup>12</sup>

## **C. Regulatory stakes: an apparent paradoxical situation**

In the regulatory field, what is striking is the apparent paradox between the relatively loose regulation of CRAs and their growing role as part of the regulation system.

### **1. A growing recourse to financial rating agencies**

Recent legislative reforms have granted the CRAs a quasi regulatory function. In French law, vehicles for securitization (“fonds commun de créances”) are compelled to be rated before being listed.

To a lower extent, the same pattern arises in other segments of the financial market. The Euronext regulation points at the possibility to ask to be rated before listing a security. The same optional power is discretionarily granted to the French regulator on all markets.

In the US, the SEC grants the quality of nationally recognized statistical rating organization (NRSRO).

However, the CRAs’ role has greatly expanded with the Basel II convention. Although optional, they now have a major role in certifying the quality of the internal process to monitor risks.

### **2. The relative lack of liability and regulation**

From a theoretical point of view, all the above mentioned flaws in the methodology should be compensated for by an ex post liability mechanism. Despite

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<sup>11</sup> Among others: CANTOR and PACKER (1996); GESSOUM (2004).

<sup>12</sup> See section III, paragraph C. below.



this growing regulating function, CRAs still enjoy a relatively total freedom. Their status as new agencies in the US gives very little room for suing them for liability. The NRSRO qualifying process has long been an assessment process rather than a monitoring process. On an international basis, IOSCO “Code of Conduct Fundamentals for Credit Rating”<sup>13</sup> is not really legally binding.

However, one can notice a recent evolution towards a more stringent regulatory framework. In the EU, directives 2003/6/CEE and 2003/125/CEE hint at CRAs and identify room for potential liability. In the US, the recent Credit Rating Agency Reform Act, 2006 establishes a registration process for CRAs. So the situation is evolving rather rapidly in terms of how the CRAs may be regulated.

This apparent paradox does not raise any question as long as CRAs are using a sound and neutral methodology in order to assess an operation. This is the question we raised in the realm of the legal field.

### **III. Section III: Description of the findings: a questionable methodology**

#### **A. A rather non transparent methodology**

As a caveat, we should stress that we do not use the words “transparency” and “transparent” in any derogatory meaning. Legally speaking, transparency means a certain set of procedures. As an example, in order to define this concept, we can use the European court of justice case law on public procurement<sup>14</sup>. We could then define here transparency as a combination of:

- a published methodology, devised after discussion with stakeholders;
- an automatic decision process according to this methodology, enforcing the non discrimination principle;
- and, most of the time, an appeal process abiding by the “fair trial” principle.

The activity of rating agencies and more particularly the rating process is not subjected to particular procedural requirements. Indeed, if the IOSCO enumer-

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<sup>13</sup> IOSCO, Technical committee (2004.).

<sup>14</sup> See, for instance: ECJ, 7 December 2000, Teleaustria.

ates a series of principles relative to the “Quality of the rating process”,<sup>15</sup> those remain very general and do not directly relate to the process to be followed to give a rating. Thus our working group conducted a series of interviews in order to open the apparent “black box” of the rating methodology.

## **1. The rating methodology: general overview**

Generally speaking, rating results from a collegial decision made by several analysts who are internal experts.<sup>16</sup> But the method employed by rating agencies remains relatively not procedural, for instance, the composition of the experts committee is not always the same and varies according to the sector, the geographical area, competences, etc.<sup>17</sup> It differs from one agency to another.<sup>18</sup>

The rating is then permanently monitored by the agencies in order to account for the evolution of the credit quality. The note could be modified according to internal as well as external new information. This calls into question in more details how rating agencies assess the legal environment.

## **2. Rating the law: a surprisingly “handicraft” process**

When assessing the legal framework of a rated entity, the method also relies on committees, like the production of the whole rating itself. There are of course differences between agencies. However, the major differences lie in the methodology used according to the nature of the entity rated – from sovereign debt to structured finance product.

### **a) The internal management of the legal function within the CRAs**

Concerning the legal aspects of the rating, and more generally of the institutional setting, the common pattern is that, although each agency heavily relies on external legal advisory services, it also devotes specific means to the legal component of the rating. However, internal legal services appear to be of small scale. Despite the small size of these services, one finds significant differences between each rating agency. For instance, one agency has twelve lawyers, an-

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<sup>15</sup> IOSCO (2004).

<sup>16</sup> B. QUENTIN, Les agences de notation, *Revue de Droit Bancaire et Financier*, No. 6, nov./déc. 2004, p. 465.

<sup>17</sup> Rapport AMF sur les agences de notation pour l’année 2004 (31 janvier 2005), p. 48.

<sup>18</sup> All the information concerning the practical application of legal criteria and referred to in this article can be found on Internet websites of the three agencies (Moody's: [www.moodys.com](http://www.moodys.com), Standard & Poor's: [www.standardandpoors.com](http://www.standardandpoors.com); FitchRatings: [www.fitchratings.com](http://www.fitchratings.com)).

other has three lawyers for European cases and six devoted for cases concerning the rest of the world.

**b) The focus on legal issues according to the nature of rated entity: the emblematic case of structured finance**

If rating agencies apprehend differently the legal factor, one can also note the existence of methodological divergences according to the kind of rated object. Thus, especially as regard sovereign rating (and to a lesser extent, for corporate rating), legal factors have a narrow influence on the final rating.

This contrasts with the case of new financial instruments in the field of structured finance, in particular for securitization operations, where the legal framework plays a much bigger role, if not crucial. Indeed, for this kind of operation, the arranger which makes the transaction chooses the legal environment, and often the legal jurisdiction, in which the transaction will be held. This choice may be derived from the level of the rating, which itself is based on the assessment of the soundness of the legal arrangements by the agencies.

Rating agencies have thus been forced to develop new tools to gradually apprehend these new and diverse financial products. The agencies now have analysts specifically assigned to securitization operations. Their operating mode is similar with the general rating process described above.

To assess the legal framework, the agencies frequently employ a small group of external law firms in order to obtain a precise description of the legal risks and a legal opinion on the quality of the true sale. The role of these practising lawyers is thus very important and rating agencies are largely dependant on their legal opinion.

Three patterns are particularly striking. First, the agencies oligopoly is mirroring with a similar oligopoly of lawyers. The arguments behind are: 1/ that this oligopoly is due to the sophistication of the legal arrangements used and 2/ by a “regulation by reputation” process.

Second, although the CRAs may hire their own attorneys, they most of the time rely on the issuers’ attorneys. Third, the assessment process is that of a bilateral bargaining between the agency and the external attorney. The bargain is based on two parameters: the capacity of the attorney to persuade its counterpart in the CRAs, and the precision of the wording used to draft its legal opinion.

As a matter of fact, these legal opinions are a way for the CRAs to pass their liability through onto that of the lawyers. This is especially the case since these external attorneys are not formally contractors of the CRAs but of the issuers.

The question is of course how this methodology is actually implemented, what are its results and especially if this process does not generate structural biases. Clearly, there is no reason to suspect the skills and professionalism of the lawyers involved externally as issuers' attorneys. As well, the professionalism and knowledge of the internal legal counsels are unanimously praised. Sometimes, they were among the best issuers' attorneys before being hired by agencies to test the quality of legal opinions.

However, our inquiry shows that this methodology does not prevent the rating process to be exempted from prejudices according to the origin of the legal framework. We tried to identify these prejudices, if not quantify them.

## **B. The effect of qualitative biases**

The assessment of qualitative biases is a complex issue. This section is divided in two parts. First presents our main findings. Second discusses them in respect of the main debates of the law and economics theory.

### **1. Findings**

Our research showed that, generally speaking, CRAs have an indirect, yet strong influence on the choice of the legal arrangements used by issuers. From a practical point of view, yet indirectly, CRAs issue implicit prescription in favour of certain specific legal arrangements coming from specific legal traditions. This normative process is implicit to the extent that no agency positively recommends any kind of legal instruments. Since their role is to assess the soundness of a legal arrangements or framework, their assessment works as a "pass or fail" test. Therefore, it is more from their rejection statements that one can derive what patterns are the most preferred by CRAs. And since these rejection statements finally lead to a change in the statute law, the normative impact of CRAs can be monitored through explicit reforms of law.

Through interviews corroborated by a review of the legal literature, we've identified such influence in at least three cases related to the recent evolution of French Law:<sup>19</sup>

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<sup>19</sup> We once again refer the reader to the full paper in French.

- pertaining to the so-called “solidarité de place”: a specific systemic banking solidarity enforced by the Governor of the French Central bank according to the then art 52 of the 1984 Banking Act; pertaining to the so-called “comptes d’affectation spéciales”: a commonly agreed system which allows, under specific and precise conditions, incomes from customers to fall out of the scope of bankruptcy law;
- pertaining to a category of hybrid capital bonds: the “titre super subordonné à durée indéterminée”.

The conclusions of our research can be briefly summarized as follow. In these instances, CRAs are enforcing an asymmetric approach: in favour of written law rather than case law, and in favour of British or US law rather than French law.

If a legal arrangement is supported by a long standing and consistent case law from the French Supreme Court, then a) CRAs will need to have this arrangement confirmed by a statute law to waive their no objection statement and b), however, CRAs do not impose the same precautions as far as British or US case law is concerned. One has to stress that, in the case of “comptes d’affectation spéciales”, the legal arrangements proposed by the issuers was using a long standing – at least a decade old – case law from the Cour de cassation, the French Supreme court, but in another realm. So the soundness and the effectiveness of this arrangement was very little put into question in the legal community.

Of course, the test carried out by CRAs may prove highly necessary. As a matter of fact, the example of the “solidarité de place” system demonstrates that CRAs may play a very efficient and useful “screening function”. According to art. 52 of the Banking Act, this system imposed to all banks operating in France to rescue a failing bank when “invited” to do so by the Central Bank governor. CRAs have never been convinced by the effectiveness of such an obligation and by the obligation of the Governor to use this measure. And actually, the effect on banks of the 1990s real-estate crisis proved that they were right.

From another point of view, the reluctance of CRAs towards some specific legal arrangements may express the mere effect of the role of rating agencies. Since they give information on the probability of the issuer to default or of the bond holder to get a fair repayment in such case, they can not be blamed to tend to be overcautious.

However, we tried to check if this cautiousness is based on sound legal analysis and may not be systematically framed, from a quantitative point of view.

## 2. Discussion

Our findings reveal that CRAs tend to give an excessive weight to legislative statutes. The rationale behind may be that legislative statutes enhance the legal certainty because they are more stable than case law and are less subject to interpretation. However, this argument proves to be problematic because legislative statutes do not constitute a guarantee against future misinterpretation by judges. We refer here to the traditional debate between “law in the books” and *ex post* enforcement of law.<sup>20</sup>

This debate echoes traditional posnerian discussion between the relative economic capacities of common law and civil judges. According to the posnerian initial approach, common law judges would be more efficient.<sup>21</sup> This statement expresses an unjustified bias against civil law which is actually as stable as in the common law courts.<sup>22</sup> Among other criticisms that can be opposed to Posner’s analysis one can stress a misunderstanding of the sociology of civil law judges. Contrary to the argument that civil law judges are not used to the reality of business, one should note for instance that French bankruptcy judges are former businessmen, if not former bankers. Thus, they prove to be at least as served as common law judges in commercial and insolvency affairs.

### C. The quantitative effect of using questionable composite indicators

Our working group studied how rating agencies take into account national differences in corporate bankruptcy laws. Corporate bankruptcy law became a key issue during the Nineties with the rise of financial leverage instruments, in particular LBOs. We made a quantitative test on FitchRatings’ data which are easily available and which methodology relies heavily on a quantitative approach. FitchRatings provides useful and numerous documents to explain the links between corporate bankruptcy law and its “notching up” policy for the rating of financial instruments<sup>23</sup>. For instance, when a company launches a loan, the agency proceeds the following way. The reference is the initial rating of the company, let us say B, then, according to the instrument characteristics (collateral nature...), this first rating can be notched up, for example rated B+,

<sup>20</sup> See KAUFMANN et al. (2005); MENARD and DU MARAIS (2006); HADFIELD et al. (2005).

<sup>21</sup> POSNER (1998).

<sup>22</sup> DEFFAINS (2005).

<sup>23</sup> FitchRatings (1999), *Regimes, Recoveries and Loan Ratings: the importance of insolvency legislation*; FitchRatings (2006), *Country Specific Treatment of Recovery Ratings – Revised*.

BB- or even BB. The instrument rate can be increased up to three notches beyond the initial rate of the company. The frequency and the extent of the notching up depend on the assessment of the national corporate bankruptcy law. More precisely, the more creditor friendly a bankruptcy law is assessed, the higher are the extent and the frequency of the notching up<sup>24</sup>. In other words, the more the creditor friendliness of the bankruptcy law, the larger the probability to obtain a higher rate than the initial one is.

The difficulty consists in evaluating the degree of creditor friendliness of the law. The method consists in building a scale in order to distinguish clusters of country. These clusters are based on PHILIP WOOD / Allen & Overy LLP's "Maps of World Financial Law"<sup>25</sup> and World Bank's governance indicators are used. It appears that these sources are questionable.

For instance, first source gives account of "the general ethos" of the legal environment. Two elements are taken into account: the legal family of the law<sup>26</sup>, and individual characteristics for each jurisdiction which measure creditor friendliness. A grade is allotted for each element, then a weighted average is calculated to give a first rating to assess the general legal environment. The agency states that this process accounts primarily for the membership to a legal family according to Wood's maps. For instance, English common law is considered to be the most creditor friendly whereas Islamic laws are considered to be the least. One has to note that Wood's maps are controverted among lawyers<sup>27</sup>.

Then three governance indicators provided by the World Bank are used: Government Effectiveness, Rule of Law and Control of Corruption. A complementary source is also used: Doing Business' reports. More precisely, the used variable is the indicator Time which measures proceedings length from the chapter intituled Closing a Business. A grade is allotted by FitchRatings to each of these indicators, then a weighted average is calculated. This rate is aimed at accounting for the effectiveness of law.

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<sup>24</sup> One should note that this positive assessment for creditor friendly law is not justified by the agency in spite of its doubtful validity. To deal with this issue one can refer for instance among others: ATTİYAS (1995), Bankruptcy Policies: a Comparative Perspective, Working Paper, Private Sector Development department, The World Bank; EBERHART A.C. and SENBET L.W. (1993), Absolute Priority Rule Violations and Risk Incentives for Financially Distressed Firms, Financial Management, vol.22, No. 3, p.101-116.

<sup>25</sup> WOOD PHILIP / Allen & Overy LLP (2005), Maps of World Financial Law.

<sup>26</sup> English common law, Napoleonic code, Us common law, Roman-Germanic code, mixed common law / civil code, islamic law et news states, CIS.

<sup>27</sup> F. ODITAH (1990), English and International Set-Off, Law Quaterly review, 106, p. 515-521.

The use of some of these indicators raises a few doubts. Their validity is called into question<sup>28</sup> or they are built in a very subjective way, even according to their author<sup>29</sup>. We tried to assess the sensitivity of the rating with regard to the subjectivity of the indicators. In particular, we concentrated on the assessment of differences between French and American corporate bankruptcy law. Indeed, both share a common prospect in favour of debtors (LLSV, 1998), as FitchRatings itself stresses. Moreover, in spite of belonging to a common law country, American bankruptcy law is governed by a code. We realized a partition by referring only to World Bank's data, (thus, we did not take into account Wood's maps) which leads to classify the two bankruptcy laws within the same class (see the first appendix). The initial ranking makes American bankruptcy law belong to class A, while French bankruptcy law belongs to class B and thus is submitted to a more severe notching policy, all other things being equal. If one refers to the standard scale used by the rating agencies, this severity can be assessed to lead to an average underestimation of at least 3.33 percentage points for France<sup>30</sup>.

This comparison shows that the simple use of questionable external indicators is not without consequences for the proposed ratings and can lead to unduly hamper the economic performance of enterprises by making financing conditions harsher (see the second appendix). Moreover, they can suffer in their access to the financial markets from a confidence deficit from potential investors which would form their judgement on behalf of ratings proposed by rating agencies.

## IV. Section IV: Conclusions

Our research has confirmed two of the initial assumptions. CRAs do use in their methodology some composite index of the quality of law. Therefore, if these indexes are fraught with structural biases, these biases may diffuse through CRAs rating to operations in the financial markets and then create a competitive disadvantage to some issuers.

<sup>28</sup> DU MARAIS B. (2006), Les limites méthodologiques des rapports Doing Business, document de travail AED-2006-1.

<sup>29</sup> WOOD, op cit. p. 13.

<sup>30</sup> Indeed, rating agencies scale comprises 10 principal stages which can be broken up, thanks to the notching up into three stages (for example, the stage B breaks up into B -, B and B+). On a scale going from 1 to 100, each stage counts for 10 % of the maximum note, and each under stage (correspondent with a one notch unit) accounts thus for  $1/3 \times 10$  % that is to say: 3,33 % of the maximum rate.



Secondly, there exists a “legal origins” bias in the rating process.

We’ve tried to quantify this bias through a sensitivity test of one the CRAs rating process: namely, “Recovery rating”. We found this bias to have, on average, a negative effect of one “notch” for French vehicles for structured finance. This bias is, at this stage of our research, merely due to the use of P. Wood’s indicator “Maps of World Financial Law”.<sup>31</sup> By construction, these maps have a strong bias towards some legal culture (in favour of common law and, to a lesser extent, in favour of “Roman-Germanic law”, which is, surprisingly, considered as very different from “Napoleonic Law”).

However, we must admit that the focus on this indicator is largely accidental. We’ve chosen this indicator due to information availability. So this test can clearly not be considered as done on a significant sample of the CRAs methodology.

Through qualitative interviews and case studies, we’ve also identified some influence of the preference of CRAs for: a) statute law rather than case law, b) and in all cases, for common British or US law.

In terms of financial market regulation, this shed a new light on the methodology of CRAs and its operational effect. First of all, this bias is, at least, neutral in terms of credit default assessment, when it is not negative. If the legal framework favoured by CRAs were outstandingly “better” than other legal arrangements or traditions, then this bias would have a positive effect in terms of certainty of the deal for investors. However, it is rare in the legal practice, that one can judge a legal arrangement far more reliable than another only by resorting two criteria: a) the fact that it comes from an Official Gazette rather than from a Court record, b) the legal traditions in which it has been originated. Furthermore, there remains to be seen if the fact to recommend a foreign jurisdiction and law does not raise, by itself, some internal risks. These risks may especially happen when it comes to contracts implementation by the parties and to their enforcement in foreign courts.

From a more macroscopic point of view, one may wonder if this bias is not comforting the integration of the financial industry, around the more preferred legal framework and not according to an objective assessment of its quality. By expressing a general preference, CRAs may actually constructing barriers to entry for legal arrangements coming from other legal framework. The same reasoning can be developed in terms of financial innovation. The legal preferences expressed by CRAs may actually discard legally innovative arrange-

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<sup>31</sup> WOOD (2005).

ments based, for instance, on legal concepts used in fields different from their initial purpose (as was the case for “Comptes d’affectation speciale”). This is especially so when CRAs prefer statutory law. During the time necessary to pass an act, most of the issuances are postponed.

From an academic point of view, these results may bring a nuance to the literature assessing the efficiency of certain legal jurisdictions to develop financial market. There might be a self fulfilling prophecy in these works, especially when they resort on CRAs data to assess the compared efficiency of financial law. Due to what seems a not enough scientifically based judgment, financial rating agencies are undervaluing the bonds and securities issued in markets belonging to the non-preferred legal traditions. Given their influence on the conditions of stock or bonds issuance, if not on their mere possibilities, one may wonder if CRAs are not participating in the overall judgement that common law is better for financial development, instead of demonstrating it. Further research could address the transaction cost of standing against this common shared opinion and then show how much the “Law and finance” theory, if tested today, is self fulfilling due to the biases we have identified.

Further research should also test if our results can be generalized to several countries legal framework and to several types of rated entities.

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Differences between FitchRatings countries classification and the classification resulting from SPAD

Pays	Fitch Rank	Spad Rank	Increase	Decrease
Belgium	2	1	1	0
France	2	1	1	0
Spain	2	1	1	0
Botswana	3	2	1	0
Bulgaria	3	2	1	0
Costa Rica	3	2	1	0
Croatia	3	2	1	0
Estonia	3	2	1	0
Greece	3	2	1	0
Hungary	3	2	1	0
Israel	3	2	1	0
Jordan	3	2	1	0
Latvia	3	2	1	0
Lithuania	3	2	1	0
Malaysia	3	2	1	0
Mauritius	3	2	1	0
Morocco	3	2	1	0
Panama	3	2	1	0
Poland	3	2	1	0
Slovak Republic	3	2	1	0
Slovenia	3	2	1	0
Thailand	3	2	1	0
Tunisia	3	2	1	0
Uruguay	3	2	1	0
Brazil	4	3	1	0
Chad	4	3	1	0
Ecuador	4	3	1	0
India	4	3	1	0
Kuwait	4	2	1	0
Oman	4	2	1	0
Saudi Arabia	4	2	1	0
United Arab Emirates	4	2	1	0
Korea South	1	2	0	1
Puerto Rico	1	2	0	1
South Africa	1	2	0	1
Taiwan	1	2	0	1
Mexico	3	4	0	1
Romania	3	4	0	1